

ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Cedillo Analyst: Jeff Garnier Bill Number: AB 1854
Related Bills: See Prior Analysis Telephone: 845-5322 Amended Date: 03/30/2000
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Earned Income Refundable Credit

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _____.

☒ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended _____.

FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO _____.

☒ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS AMENDED 3/23/2K STILL APPLIES.

OTHER - See comments below.

SUMMARY OF BILL

This bill would:

- provide a refundable Earned Income Credit (EIC) in an amount equal to 15% of the earned income credit allowed by federal law;
- provide that the Franchise Tax Board (FTB) shall train and inform employers regarding how employees may make withholding adjustments to reflect the credit; and
- include the refundable EIC in the list of credits that can reduce regular tax below tentative minimum tax (TMT) for purposes of alternative minimum tax (AMT).

SUMMARY OF AMENDMENT

The March 30, 2000, amendment deleted language that would have prevented non-residents (including part-year residents) and taxpayers without a qualifying child from qualifying for the credit, thus allowing the credit to these individuals. The amendment removing the restriction on non-residents resolves a Constitutional Consideration stated in the March 23, 2000, analysis.

The amendment also would provide that any refunds of the credit would be treated the same as the federal EIC in determining if an individual qualifies for benefits under Division 9 of the Welfare and Institutions Code. The federal EIC is not considered in determining if an individual qualifies for welfare. This provision does not impact the department and will not be included in this analysis.

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director

Date

Alan Hunter for G.H.G.

6/8/00

REVISION TO PRIOR ANALYSIS

This analysis revises the Department's bill analysis dated March 23, 2000. The prior analysis stated that the EIC would be a state public benefit under federal law. As a public benefit the Department would have been required to verify that certain illegal aliens would not receive the EIC. Upon further review by the Department's legal staff, which included consulting other states with refundable EICs and several federal agencies including the Immigration and Naturalization Service and the Department of Health and Human Services, it has been determined that this proposal would not create a state public benefit for purposes of Title IV of the Personal Responsibility and Work Opportunity Act of 1996. This change affects the "Fiscal Impact" section of the prior analysis.

Additionally, the departmental costs are being revised to reflect a more detailed costing analysis of this bill.

EFFECTIVE DATE

This bill would be effective immediately upon enactment and would apply to taxable years beginning on or after January 1, 2000, and before January 1, 2005.

SPECIFIC FINDINGS

Except for prohibiting non-residents and single taxpayers from claiming the credit, the change regarding conclusion concerning the credit as a state public benefit, and the reversion to departmental costs, the prior analysis dated March 23, 2000, still applies. The "Implementation Considerations" and "Technical Consideration of the March 23, 2000, analysis are included in this analysis. One additional implementation concern is being added to this analysis.

Existing federal law allows eligible individuals a refundable EIC. A refundable credit allows for the excess of the credit over the taxpayer's tax liability to be refunded to the taxpayer. The credit is a percentage of the taxpayer's earned income and is phased out as income increases. The percentage varies based on whether the taxpayer has qualifying children.

The **federal** credit for the 1999 taxable year is determined as follows:

Eligible Individual with	Earned Income	Completely Phased-out @	Credit Percent.	Max. Federal Credit	Max. Proposed State Credit
1 qualifying child	\$6,800	\$26,928	34%	\$2,312	\$346.80
2 or more qualifying children	\$9,500	\$30,580	40%	\$3,816	\$570.90
no qualifying children	\$4,500	\$10,200	7.65%	\$347	\$52.05

This bill would specify that individuals qualifying for the federal credit would qualify for the state credit. The state credit would be equal to 15% of the federal credit.

Implementation Considerations

This bill would require an appropriation of money by the Legislature to pay refunds authorized by this bill. Disallowance of refunds to some taxpayers could result if the amount of refunds claimed exceeds the funds appropriated. Prior to approval of a continuous appropriation, refunds of the refundable renters' credit were delayed and interest had to be paid to taxpayers until more funds were appropriated to cover claims in excess of the initial appropriation. If funds are not available to cover refunds due under this bill, payments of interest to refund recipients and additional departmental costs associated with additional calls to the service center inquiring about delayed refunds would result.

Many taxpayers eligible for the federal EIC probably have little or no federal or state tax liability and do not have a California filing requirement. Some 600,000 current non-filers would be required to file tax returns to claim the proposed EIC, which would significantly impact the department's programs and costs.

The Internal Revenue Service (IRS) completes tax returns for some taxpayers who claim the refundable EIC. Since the proposed California EIC would be based on a percentage of the federal EIC, these taxpayers may expect the FTB to calculate their proposed California EIC. The FTB does not have ready access to the federal modified adjusted gross income figures (non-taxable and taxable earned income) that are used for the federal EIC calculation; therefore, the FTB would be required to request this information after the filing season and store additional documentation on these taxpayers. This would result in additional departmental costs.

Refund returns generally are filed early in the filing season. If taxpayers claiming the California EIC file late in the filing season after they receive their federal EIC, that behavior could have a major impact on the processing of returns and possibly cause delays in the issuance of refunds.

Taxpayer error rates on the federal EIC, as well as fraud concerns, cause the IRS to adjust many returns. Consequently, the correct federal EIC amount may not be known until after the taxpayer has filed the state return and claimed the proposed California credit. The FTB would then have to issue an assessment to retrieve refunds improperly made. This would result in additional departmental costs.

This bill would require the FTB to provide training and information directly to employers; however, the Employment Development Department (EDD), rather than FTB, advises employers on matters relating to withholding. If such information could be provided indirectly through FTB's normal methods for providing information to tax preparers and taxpayers (i.e., instructions with tax forms, the Tax News newsletter) or through EDD advisories, this provision would not cause significant implementation issues. If this department were required to contact all employers in the state, significant resources would be required to implement this provision. Clarification is needed before the department could implement this portion of the bill.

Under specific provisions of federal law, denial of the EIC is treated as a deficiency, subject to protest and appeal. The bill does not specify protest and appeal rights in connection with denial of the proposed California EIC. It is unclear when denial of the state EIC would be subject to protest and appeal.

It is unclear if taxpayers would be ineligible for the state credit because of reckless or intentional disregard of the rules or because of fraud in claiming the state credit as provided for the federal credit under federal law.

This bill would allow a credit that is not in whole dollar amounts. It would be cost effective to round the credit amount to the nearest whole dollar.

Technical Consideration

Amendment 1 is provided to remove an obsolete reference to the refundable renters' credit.

FISCAL IMPACT

Departmental Costs

First year implementation costs are estimated at \$13.3 million and ongoing costs are estimated at \$9.6 million per year. These costs are down from \$13.9 million and \$11 million, respectively, from the March 23, 2000 analysis. The estimate includes \$1.2 million and \$1 million respectively for additional leased facilities.

The estimated costs are associated with the printing and processing returns for new filers who currently do not have a filing requirement, but would file solely to claim the refundable EIC. These returns are estimated at 650,000 for the first year and 540,000 returns thereafter. The costs also include processing of an estimated 2.5 million current filers in the first year and 2.1 million thereafter who would qualify to claim the credit.

The addition of the EIC to the tax forms and instructions would cause the 540NR form to expand to another page. The additional page of the tax return would significantly slow the processing of 540NR returns.

The credit is based on the allowance of the credit at the federal level. It is not possible for the department, during processing of the state return, to determine if the federal credit was allowed. To avoid the risk of paying interest on the refund created by the credit, the FTB would be required to calculate the credit for federal purposes and then apply 15% for state purposes. Computer processing systems will have to be modified to calculate the federal credit.

In addition, because of the fraud potential associated with any refundable credit, returns will be reviewed at a higher than normal rate of 35% for new filers and 25% for current filers. A quality review (or second review) would be performed on 45% of the returns selected for the first review.

Other costs include changes to the computer systems that currently do not contain logic to process a refundable credit, increased taxpayer phone calls and correspondence, and electronic and paper storage. The department has no additional space to expand its current operations. The department would work within available space to the extent possible; however, this bill would require significant amounts of additional building space to process this credit, which may include leasing additional office space and file storage space.

Significant costs may be generated if the department has to collect erroneously issued refunds due to fraud or federal EIC adjustments.

Departmental costs associated with providing training and information to employers cannot be determined until this provision has been clarified.

Tax Revenue Estimate

This proposal is estimated to impact PIT revenue as shown in the following table.

Fiscal Year Cash Flow Taxable Years Beginning After December 31, 1999 Enactment Assumed After June 30, 2000 \$ Millions		
2000-01	2001-02	2002-03
-\$609	-\$620	-\$636

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion:

The revenue impact for this bill will be determined by the number of qualifying taxpayers and the amount of earned income on which the credit is based.

These estimates were derived from the Department's Personal Income Tax Model and usage of the federal EIC, grown by the U. S. Treasury growth rates specifically for the federal EIC.

BOARD POSITION

Pending.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 1854
As Amended March 30, 2000

AMENDMENT 1

On page 7, line 27, strike "or subdivision (j) of Section 17053.5"